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Cox Communications

November 27, 2001

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Recommendation: Sell

Price: $39.57 Target: $33

Investment Conclusion

We are initiating coverage on Cox Communications with a Sell rating. The outlook for the cable company is not as promising compared to some of its competitors. With the recent downturn in the economy, Cox has altered its strategy from acquiring new customers to cutting costs. This could hurt their growth potential in the long run, as its competitors continue to aggressively push into digital penetration and VOD capabilities. The following points which are described in more detail in the following section are our main reasons for issuing the sell rating.

- The company's shares currently sell at a relatively high Enterprise Value/2002E EBITDA ratio of 16.7 compared to its competitors, which trade around 14 times 2002E EBITDA.

- Competitors are growing their subscriber bases more aggressively than Cox Communications.

- Reduced marketing expenses and capital expenditures to deploy digital and VOD capabilities will limit growth potential.

- The uncertainty over the expectation as to who wins the bidding for AT&T Broadband.

Outlook

For the first 9 months of 2001, Cox revenues grew 14% compared to the same period for 2000. We expect Cox's revenue to grow at the industry average of approximately 14% over the next year and also expect higher EBITDA growth in 2002 of close to 16%.[1] However, we expect growth to slow down to normalized revenue growth of 9% and EBITDA growth of 7% in the longer term. Cox currently trades at a strong premium to its competitors, who have recently had superior rates of increase in their subscriber bases, notable among these is Charter Communications.

Cox's shares currently sell at a relatively high EV/2002E EBITDA ratio of 16.7, compared to its average peer valuation of approximately 14 times. The cable sector has historically traded at price/EBITDA ratios between 13 and 15, but the sector has recently come under pressure.[2] Cox has maintained an EV/EBITDA multiple above the average industry range of 13 to 15, but we expect that the stock will trade back into the average industry range over the near term.

In addition, Cox has reduced its marketing expenses in 2001. The company already lags its competitors in Digital Cable TV penetration, and its cutbacks will not help it to regain ground. Upgrading to digital cable is an important step in offering video on demand capabilities, which will lead to higher revenue per subscriber. Without a concerted effort to convert its base to digital television, the company faces some lag time in adding projected VOD revenues.

Cox also faces uncertainty regarding its source for high speed internet providers. Cox's main Internet service provider, Excite@Home, filed for bankruptcy in 3Q01. Cox has recently announced that Earthlink and AOL will be offered as choices for ISP's for their high speed internet service.[3]

Video on Demand is considered the cable industry's differentiator with response to competition from satellite providers. Cox has started to roll out VOD, but has been less aggressive than its competitors. In order to successfully push VOD, the company must convert a majority of its users to a digital platform. In addition, the company also has not actively pursued arrangements with studios to provide content for its VOD services.

A 2002 recession could adversely affect Cox. The company's future earnings presume significant growth in "luxury" premium cable features such as Digital TV and Video On Demand. The company's bundling of features will deter customers from switching, but not from simply reducing their household's cable service to a more basic and inexpensive level.

AT&T broadband is on the selling block, and Cox is one of the bidders for a unit which controls nearly 14% of the current cable market, lagging only behind AOL.[4] With Comcast and AOL chasing AT&T broadband, Cox would likely have to make a very aggressive bid for the unit. With a bidding war likely to happen amongst these three leading players, it is apparent that one of these MSO's is going to overpay for AT&T Broadband, and Cox could be one of those players. Since AOL TimeWarner can extract the most value per customer, we expect AT&T Broadband to be most valuable to AOL. Our concerns involve Cox overpaying for the unit, which would adversely affect the stock price.

[1] Cox Communications Q3 2001 Earnings Release.
[2] Morgan Stanley, Broadband Cable Television, July 3, 2001.
[3] Cox starts high-speed trials with AOL, EarthLink. November 6, 2001. Reuters.
[4] Bartash, Jeffrey. "AOL joins race for AT&T broadband" November 16, 2001. cbs.marketwatch.com.

Company History

Cox Communications is owned 67% by Cox Enterprises. Cox Enterprises began as a newspaper chain in the early 1900's, and by the 1950's the company had expanded into radio and TV stations. Cox was one of the first companies to invest in cable TV in the early 1960's, and in 1964 Cox Broadcasting was created. In 1968 Cox Cable Communications was created as a subsidiary of Cox Broadcasting, and in 1982 the two were merged and renamed Cox Communications. In 1985, Cox Enterprises purchased a majority stake in Cox Communications. Throughout the 1990's, Cox Communications aggressively expanded its cable TV network through a series of acquisitions and swaps. Most notably, the company swapped AT&T stock for AT&T's cable TV network. Cox has also engaged in swaps with Time Warner and US West, each time expanding its cable TV network. Cox is now the 5th largest cable network in the United States.[5]

Overview

- Cox provides cable TV service to over 6 million households in the United States.

- Cox bundles services for households, providing subscribers with a number of options for their television and networking needs.
    - Cable TV, including Digital TV
    - High-speed data service for Internet access (modem)
    - Telephone service

- Bundling provides Cox with a mechanism to better market its services to customers. This is a good mechanism to ward off DBS providers and offer better internet connectivity solutions than the typical 56k connection. Cox has also been one of the few cable companies to push for telephony bundling allowing them to offer three services instead of two. Cox tested its inelasticity of demand for its high speed internet services in 2001 with a cable modem rate increase of $5 per month and few customers switched.[6] With bundled services, customers are unlikely to cancel subscriptions if they have more than one service offered by a provider.

- The company has focused 75% of its infrastructure investment in only 15 urban markets, and its largest market is Phoenix. [7] Clustering its customers provides Cox with economies of scale.

- The largest competitors for the cable TV industry are Echostar and DirecTV, or satellite TV. DBS providers do not allow 2-way communication, so it cannot provide the bundled Internet or telephone service that cable can currently provide. Cable will be the leader in offering interactive television in the future, as it already has made inroads to supply video on demand. VOD allows subscribers to select videos to watch. The current limitation on VOD is the right to offer studios' content.

[5] Bernter, Todd. Morningstar. "Cox Communications" November 16, 2001.
[6] Bernter, Todd. Morningstar. "Cox Communications" November 16, 2001.
[7] Morgan Stanley research, Cox Communications, October 26, 2001

Past Performance

Cox has changed its corporate strategy during 2001. For the past several years, the company has focused on maximizing its revenues and growth. It has done this by increasing its marketing and customer service staff, and offering discounts on price. The strongest marketing campaign was in June 2000, and the company saw significant increases in new telephone and Internet data customers.[8] Growth has been 15% per year, which is similar to the other fast-growing cable providers. However, during 2001, Cox has begun to control costs more assiduously, and so has reduced revenue growth in favor of EBITDA growth. For example, Telephony marketing expense fell from 12% of revenue in 2000 to only 8% of revenue in 2001E. Telephony G&A expenses fell from 28% of revenues in 2000 to only 15% of revenues in 2001E.[9]

One fault with Cox has been its aggressive attempts to grow its telephony revenues while being more lax with digital cable initiatives. Profit margins for telephony are significantly lower than for its cable services. The result has been that Cox's growth of penetration in digital cable has been lower than that of its competitors. Cox's 2001 data modem sales were also slowed by the 3Q01 bankruptcy of its main cable modem provider, @Home. Cox has recently established relationships with Earthlink and AOL to provide ISP services to their subscribers.[10]

Cox's competitors have recently had superior rates of increase in their cable TV subscriber base. Notable among these is Charter Communications, which had a 2% increase in new cable TV subscribers during 3Q01. The industry average was 1%, and Cox only added .5% during the quarter. Previous quarters have been similar. The last significant increase in cable subscribers for Cox was a year before, in 3Q00, when the company invested heavily in customer acquisition by marketing its bundling capabilities.[11]

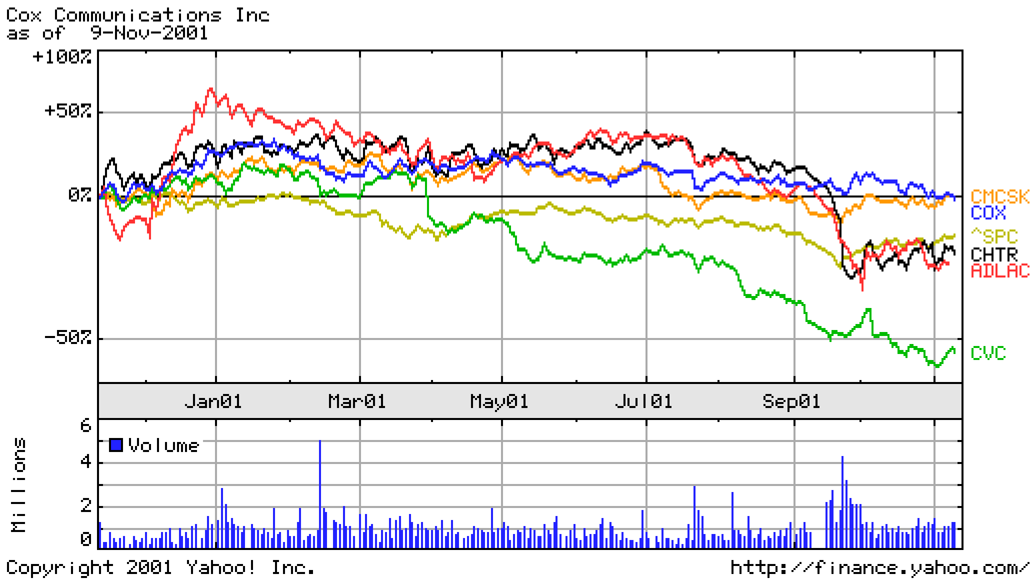
Stock Performance

Price: $39.57
52-week range: $36.00 - $50.25
Dividends: none in past 5 years
% of float sold short (November 9, 2001): 7.7%
Beta vs. S&P: .77

(source: Bloomberg, Dow Jones Interactive, Morningstar)

[8] Bernter, Todd. Morningstar. "Cox Communications" November 16, 2001.
[9] Morgan Stanley research, Cox Communications, October 26, 2001
[10] Cox starts high-speed trials with AOL, EarthLink. November 6, 2001. Reuters.
[11] Bernter, Todd. Morningstar. "Cox Communications" November 16, 2001.

Relative stock price performance



Size and Penetration of Cable Networks[12]

Firm	Homes Passed by Network	Basic Penetration	Digital Penetration	High-Speed Data Penetration	Residential Telephony
Adelphia	9,625,928	61%	18%	N/A	N/A
AOL	18,253,000	62%	17%	9%	Not offered
Cablevision	4,362,665	69%	1%	12%	N/A
Charter	11,281,142	62%	20%	6%	N/A
Comcast	14,124,304	60%	15%	3%	Not offered
Cox	9,905,182	63%	14%	9%	5%

[12] Morgan Stanley, Broadband Cable Television, July 3, 2001.

Valuation

DCF Analysis

A discounted cashflow analysis was performed to determine a fair market valuation of Cox Communications. The revenues for Cox were determined by projecting the growth of each subscriber segment in their industry. The growth in revenues per subscriber was then projected to determine the company's revenues on an annual basis. The breakdown of the projected revenue up to 2006 for the company is given in Table 1. The gross profit for each segment of Cox's business is then broken down in Table 2. The cashflows are modeled in Table 3.

Since the cable companies in general have spent millions on building out their networks, the companies have not been cash flow positive for some time. Capital expenditures are expected to decrease sequentially up until the year 2006. The working capital requirements remain constant year over year in modeling the cashflows. Depreciation is determined based on the company's current assets and their capital expenditures on an annual basis.

The company's weighted average cost of capital is calculated after determining its cost of equity and cost of debt. The company is a BBB rated company so the cost of debt is determined to have a spread of approximately 150 basis points over the risk free rate. The cost of equity is calculated using an unlevered industry beta levered to the expected long term capital structure of the firm. The optimal capital structure for Cox is approximately 30/70 debt to equity. The levered beta is approximately .77, which is comparable to a beta determined from a linear regression comparing the S&P to the performance of Cox Communications. Using the firm's capital structure, the WACC is calculated to be 8.1%, which is the rate used to discount the expected free cash flows. The perpetual growth model with a growth rate of 3.5% is used to determine the terminal value of Cox Communications. Note that the terminal value makes up nearly 93% of the total equity value of the firm.

Table 1. Revenue Breakdown

	2000	2001E	2002E	2003E	2004E	2005E	2006E
Subscribers							
Homes Passed	9,710,963	9,905,182	10,073,570	10,224,674	10,347,370	10,450,844	10,555,352
Basic Subscribers	2,018,870	2,103,421	2,174,673	2,230,078	2,286,294	2,343,332	2,401,203
Premium Subscribers	4,174,447	4,182,796	4,186,979	4,207,914	4,228,953	4,250,098	4,271,348
Digital Subscribers	841,824	1,346,918	1,885,686	2,262,823	2,602,246	2,940,538	3,234,592
HSCDS Subscribers	481,947	963,894	1,542,230	2,159,123	2,590,947	2,979,589	3,366,936
Telephony Subscribers	283,000	455,630	646,995	776,394	892,853	999,995	1,099,994
Monthly Revenue Per Sub.							
Basic Subscribers	$ 33.00	$ 34.49	$ 36.21	$ 37.66	$ 38.79	$ 39.95	$ 41.15
Premium Subscribers	$ 44.50	$ 45.97	$ 48.04	$ 50.44	$ 52.71	$ 55.08	$ 57.56
Digital Subscribers	$ 11.00	$ 11.00	$ 11.00	$ 11.55	$ 12.13	$ 12.73	$ 13.37
HSCDS Subscribers	$ 38.00	$ 34.96	$ 32.16	$ 30.56	$ 29.64	$ 29.05	$ 28.46
Telephony Subscribers	$ 52.00	$ 50.44	$ 49.94	$ 50.43	$ 50.94	$ 51.45	$ 51.96
Revenues (millions)							
Basic Subscribers	$ 799.47	$ 870.44	$ 944.92	$ 1,007.75	$ 1,064.15	$ 1,123.42	$ 1,185.70
Premium Subscribers	$ 2,229.15	$ 2,307.32	$ 2,413.56	$ 2,546.91	$ 2,674.83	$ 2,809.17	$ 2,950.27
Digital Subscribers	$ 111.12	$ 177.79	$ 248.91	$ 313.63	$ 378.70	$ 449.33	$ 518.98
HSCDS Subscribers	$ 219.77	$ 404.37	$ 595.24	$ 791.66	$ 921.50	$ 1,038.53	$ 1,150.07
Telephony Subscribers	$ 176.59	$ 275.78	$ 387.70	$ 469.89	$ 545.78	$ 617.38	$ 685.91
Total Revenues	$ 3,536.11	$ 4,035.71	$ 4,590.33	$ 5,129.85	$ 5,584.96	$ 6,037.84	$ 6,490.92
Percent Changes							
Homes Passed	1.1%	2.0%	1.7%	1.5%	1.2%	1.0%	1.0%
Basic Subscribers	1.9%	1.5%	1.2%	1.2%	1.2%	1.2%	1.2%
Premium Subscribers	-0.8%	0.2%	0.1%	0.5%	0.5%	0.5%	0.5%
Digital Subscribers	139.8%	60.0%	40.0%	20.0%	15.0%	13.0%	10.0%
HSCDS Subscribers	136.5%	100.0%	60.0%	40.0%	20.0%	15.0%	13.0%

Telephony Subscribers	100.0%	61.0%	42.0%	20.0%	15.0%	12.0%	10.0%
Monthly Revenue Growth Per Sub.							
Basic Subscribers	0.1%	4.5%	5.0%	4.0%	3.0%	3.0%	3.0%
Premium Subscribers	0.3%	3.3%	4.5%	5.0%	4.5%	4.5%	4.5%
Digital Subscribers	0.0%	0.0%	0.0%	5.0%	5.0%	5.0%	5.0%
HSCDS Subscribers	-11.1%	-8.0%	-8.0%	-5.0%	-3.0%	-2.0%	-2.0%
Telephony Subscribers	3.0%	-3.0%	-1.0%	1.0%	1.0%	1.0%	1.0%

Table 2. Gross Profit Breakdown

	2000	2001E	2002E	2003E	2004E	2005E	2006E
Gross Profit Margins							
Basic Subscribers	73%	71%	70%	69%	67%	68%	68%
Premium Subscribers	74%	74%	74%	74%	73%	73%	73%
Digital Subscribers	72%	72%	72%	72%	71%	70%	70%
HSCDS Subscribers	80%	78%	77%	76%	76%	75%	75%
Telephony Subscribers	36%	40%	43%	45%	45%	45%	45%
Total	72%	71%	71%	71%	69%	69%	69%
Gross Profits							
Basic Subscribers	$ 583.61	$ 618.01	$ 661.44	$ 695.35	$ 712.98	$ 763.93	$ 806.28
Premium Subscribers	$ 1,649.57	$ 1,705.11	$ 1,786.04	$ 1,887.26	$ 1,947.28	$ 2,050.70	$ 2,153.69
Digital Subscribers	$ 80.01	$ 128.01	$ 179.22	$ 225.81	$ 268.88	$ 314.53	$ 363.29
HSCDS Subscribers	$ 175.81	$ 315.41	$ 458.33	$ 601.67	$ 700.34	$ 778.90	$ 862.55
Telephony Subscribers	$ 63.57	$ 110.31	$ 166.71	$ 211.45	$ 247.24	$ 277.82	$ 308.66
Total Profits	$ 2,552.58	$ 2,876.86	$ 3,251.74	$ 3,621.54	$ 3,876.71	$ 4,185.87	$ 4,494.46

Table 3. Cashflow Projections

	2000	2001E	2002E	2003E	2004E	2005E	2006E
EBITDA (millions)							
CATV EBITDA	$ 1,418.74	$ 1,549.26	$ 1,789.32	$ 1,977.85	$ 2,105.10	$ 2,305.75	$ 2,469.62
Telephony EBITDA	$ 2.54	$ 44.13	$ 100.03	$ 126.87	$ 160.70	$ 180.58	$ 200.63
Total EBITDA	$ 1,421.28	$ 1,593.39	$ 1,889.34	$ 2,104.72	$ 2,265.80	$ 2,486.34	$ 2,670.25
Cashflow (millions)							
EBIT	$ 77.98	$ 38.49	$ 197.74	$ 316.22	$ 407.60	$ 564.84	$ 706.45
EBIT - taxes	$ 50.69	$ 25.02	$ 128.53	$ 205.54	$ 264.94	$ 367.14	$ 459.19
Depreciation & Amortization	$ 1,343.30	$ 1,554.90	$ 1,691.60	$ 1,788.50	$ 1,858.20	$ 1,921.50	$ 1,963.80
Capital Expenditures	$ 2,188.00	$ 2,098.00	$ 1,891.00	$ 1,701.90	$ 1,531.71	$ 1,378.54	$ 1,240.69
Working Capital Changes	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Cashflow	$ (794.01)	$ (518.08)	$ (70.87)	$ 292.14	$ 591.43	$ 910.10	$ 1,182.31
							$ 26,189.21
Discounted FCF		(518)	(71)	292	591	910	27,372

PV(FCF)		28,576
Cash		78
Long Term Debt		8,078
Long Term Growth		3.5%
Equity Value		**20,577**
Shares		601
Price per Share	**$**	**34.26**

WACC Calculation	
Target D/E	0.43
Unlevered Beta	0.6
Levered Beta	0.767
Cost of Equity	10.00%
Cost of Debt	6.00%
WACC	8.17%

Sensitivity Analysis

A sensitivity analysis was performed to see the variation in stock price with changes in projected long term growth rate and weighted average cost of capital. With growth equal to long term economic growth, and the WACC around 8 percent with current long term interest rates, the stock price would be in the range of $31.42 to 41.84 per share. Since the stock currently trades around $39.50 per share, we believe the stock is already valued at the upper end of the range. Therefore, we see very little upside potential based on the DCF analysis performed.

Table 4. DCF Valuation Sensitivity Analysis

		WACC				
		6%	**8%**	**10%**	**12%**	**14%**
Terminal Growth Rate	**2.0%**	40.85	24.12	15.75	10.73	7.39
	3.0%	58.24	31.21	19.62	13.18	9.09
	4.0%	93.02	41.84	24.78	16.25	11.13
	5.0%	197.35	59.55	31.99	20.18	13.62

A sensitivity analysis was also performed on a projected downside or upside surprise in 2002 EBITDA projections. The cable industry has traded at EBITDA multiples in the 13 to 15 range over the past several years. Using aggressive estimates of a 15 EBITDA multiple and an upside surprise of 10 percent in 2002 EBITDA, the stock would be valued at $38 per share. Given the current price of the stock, there already appears to be some good news priced into the stock. This supports our sell rating given the level of optimism in the stock comparable to its peers. We believe there is little upside potential unless Cox Communications really surprises the street with extremely bullish results. On the flip side, any negative news could send the stock to the lower end of our range, closer to the lower $30's per share which is a significant decrease from its current levels.

Table 5. Valuation based on Projected EBITDA Multiples

		EV/EBITDA Multiple				
		6	**9**	**12**	**15**	**18**
2002 EBITDA Surprise	**-10.0%**	3.54	12.03	20.52	29.01	37.50
	-5.0%	4.48	13.44	22.40	31.37	40.33
	0.0%	5.42	14.86	24.29	33.73	43.16
	5.0%	6.37	16.27	26.18	36.08	45.99
	10.0%	7.31	17.69	28.06	38.44	48.82

Comparable Company Analysis

Cox Communications was compared to the leading cable providers. After examining the price to earnings ratios, it is evident that the metric is a difficult one to use in doing any type of evaluation. Cable companies have spent so much in building and installing their network, that capital expenditures have exceeded profits for a number of years. The metric used to value most cable companies is the Enterprise Value/EBITDA ratio. Over the past several years cable companies have traded at multiples on average between 13 and 15 times EBITDA. Recently, the average cable company trades around 14 times expected 2002 EBITDA. Since Cox Communications trades at 16.7 times 2002 EBITDA, we believe it is overvalued relative to its peers. If the company were to migrate back to 13 to 15 times EBITDA, the stock price would move into the low 30's based on current estimates. There appears to be more attractive companies in the cable industry which trade at lower multiples which would offer good buy and hold opportunities.

Another metric often used to value cable companies is value per subscriber. This metric measures what each customer translates to market value for the firm. This sometimes measures the company's ability to bundle products and sell more services to individual customers, thus extracting more value from a customer. A company may also be more adept at retaining customers, which increases a customer's lifetime value to a firm. Again, Cox Communications trades at approximately $3,728 per subscriber while the industry average is approximately $3,513 per subscriber. Cox trades at a premium compared to the rest of the industry and we do not believe that this premium is warranted. Due to it trading at the high end of the range, we believe the company is exposed to more downside risk than upside potential.

Table 6. Comparable Company Analysis

Firm	Price ($)	52-week high ($)	52-week low ($)	Mkt. Cap ($M)	Debt ($M)	2001 EPS	2002 Proj. EPS	Price/ Book
AOL Time Warner	36.76	58.51	27.40	162,847	20,725	1.21	1.39	0.93
Adelphia	23.30	52.25	18.76	4,033	14,850	-3.57	-3.42	0.79
Cablevision	41.70	91.50	35.00	7,310	6,593	-2.42	-3.17	-
Charter Communications	14.78	24.45	10.49	4,348	15,655	-4.38	-4.05	1.14
Comcast	39.00	46.31	31.99	36,875	11,495	-0.80	-0.20	2.31
Cox Communications	39.50	50.25	36.00	23,716	7,847	-0.73	-0.53	2.42
RCN Corporation	3.78	19.13	1.75	368	2,497	-11.59	-10.6	-
Rogers Communications	16.30	20.44	11.00	3,415	5,370	-1.5	-1.63	-
United GlobalCom	1.72	33.81	0.50	171	12,349	-20.05	-15.86	-

Sources: Yahoo Finance, 11-27-01, 2002 estimates are from average estimates of covering Wall Street Analysts.

Table 7. Valuation by EV/EBITDA Ratios

Firm	2001E EBITDA	2001 EV/EBITDA	2002E EBITDA	2002E EV/EBITDA
AOL Time Warner	6,930	26.5	8,316	22.1
Adelphia	1,463	12.9	1,695	11.1
Cablevision	791	17.6	901	15.4
Charter Communications	1,755	11.4	2,014	9.9
Comcast	2,784	17.4	3,330	14.5
Cox Communications	1,593	19.8	1,889	16.7
RCN Corporation	(327)	-	(167)	-
Rogers Communications	936	9.4	1,129	7.8
United GlobalCom	(579)	-	25	500.8
Industry Median		**12.9**		**14.5**

Table 8. Valuation by Subscribers

Firm	2001E Subscribers	Price/ Subscr.	2002E Subscribers	Price/ Subscr.
AOL Time Warner	11,307	$ 14,402	11,535	$ 14,118
Adelphia	5,909	$ 683	5,986	$ 674
Cablevision	3,012	$ 2,427	3,060	$ 2,389
Charter Communications	6,891	$ 631	6,971	$ 624
Comcast	8,426	$ 4,376	8,517	$ 4,330
Cox Communications	6,286	$ 3,773	6,362	$ 3,728
RCN Corporation	410	$ 897	502	$ 733
Rogers Communications	2,291	$ 1,491	2,266	$ 1,507
Industry Average		**$ 3,585**		**$ 3,513**

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